The United States (US) Treasury and the Internal Revenue Service (IRS) have issued proposed regulations (REG-132881-17) on certain requirements under the Foreign Account Tax Compliance Act (FATCA) and chapter 3 of the Internal Revenue Code (the Code) that would:

1. Remove withholding on payments of gross proceeds from the regulations
2. Defer withholding on foreign passthru payments
3. Eliminate withholding on certain insurance premiums
4. Clarify the definition of investment entity
5. Provide guidance for withholding agents on certain due diligence requirements
6. Provide guidance on refunds and credits of amounts withheld

These proposed regulations are generally quite taxpayer-favorable. The removal of gross proceeds from the definition of a “withholdable payment” is most welcome by financial institutions, and the elimination of premiums for term-life and property and casualty insurance from FATCA withholding reduces the burden of FATCA compliance for virtually every US business.

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Background

FATCA is found in chapter 4 of the Code (Sections 1471 – 1474). Generally, FATCA requires US and non-US withholding agents (including foreign financial institutions (FFIs)) to identify who their payees are and the FATCA status of those payees. For FATCA purposes, US withholding agents must withhold tax on certain payments to FFIs that do not agree to report certain information to the US regarding their US accounts (non-participating FFIs or NPFFIs) and on certain payments to non-financial foreign entities (NFFEs) that do not provide information about their substantial US owners to withholding agents. The US has entered into numerous Intergovernmental Agreements (IGAs) to minimize the impact of FATCA on a foreign-partner jurisdiction’s financial institutions (FIs).

Chapter 3 of the Code (Sections 1441 – 1446) generally requires withholding at a rate of 30% on US-source fixed or determinable, annual or periodic income paid to nonresident aliens.

In January 2017, the IRS released several information reporting and withholding regulation packages: final and temporary regulations providing further guidance under FATCA (TD 9809); final and temporary regulations under chapters 3 and 61 (TD 9808) of the Code that finalized previously issued proposed regulations with some modifications; proposed regulations under chapter 3 (REG-134247-16); and proposed regulations under FATCA (REG-103477-14) that specifically address certifications and verification requirements imposed on foreign financial institutions and their sponsors.

In June 2017, the IRS published corrections to the FATCA and chapter 3 regulations issued in January of that year (i.e., TDs 9809 and 9808). The FATCA regulations published in TD 9809 and corresponding corrections published in June 2017 are referred to collectively – in the Preamble to the current proposed regulations and herein – as the “2017 chapter 4 regulations.” The regulations published in TD 9808 and corresponding corrections are referred to as the “2017 coordination regulations”.

Under Executive Order 13777, the Treasury Department was tasked with reducing the burden of existing regulations. To this end, Treasury requested comments on guidance to be modified; in response to those requests, it received several recommendations to modify the regulations under chapters 3 and 4.

Proposed regulations

In an effort to reduce taxpayer burdens and to respond to comments received, the proposed regulations include amendments to the regulations under FATCA and chapter 3, as described later. The Preamble to the proposed regulations states that taxpayers may generally rely on the rules therein until final regulations are issued, with certain specified exceptions and certain provisions applying to all open tax years, relieving withholding agents from any related underwithholding tax liability that may have occurred in prior years.

1. Removal of withholding on payments of gross proceeds under chapter 4

Under Sections 1471 and 1472, withholdable payments made to certain foreign FFIs and NFFEs are subject to FATCA withholding. Section 1473 defines “withholdable payment” to include any gross proceeds from the sale or other disposition of any property of a type that can produce interest or dividends from sources within the US. Treasury and the IRS have received comments about the burden of implementing the withholding requirement on gross proceeds. In response, the Government has repeatedly delayed the date on which such withholding would begin. The 2017 chapter 4 regulations provide that such withholding will begin on 1 January 2019.

Treasury and the IRS have now determined that withholding on gross proceeds is no longer necessary in light of current compliance with FATCA. Accordingly, the proposed regulations would remove this requirement by removing the reference to gross proceeds in the Section 1473 definition of “withholdable payment” and making necessary corresponding changes.

While this change was long-anticipated by the financial services industry, it is still a tremendous relief to see the removal of gross proceeds withholding from the regulations. While the IRS could choose to modify the regulations to once again require withholding on gross proceeds, that possibility seems very remote.

2. Deferral of withholding on foreign passthru payments

Participating FFIs must withhold on any passthru payments made to their recalcitrant account holders and to nonparticipating FFIs. Similar to withholding on gross proceeds, Treasury and the IRS have previously deferred
the date when withholding on foreign passthru payments would be required, and also have not yet provided a definition of passthru payments. Commenters have suggested that withholding on such payments might be unnecessary in light of the number of IGAs in effect.

The proposed regulations further extend the time for withholding on foreign passthru payments. A participating FFI will now not be required to withhold tax on a foreign passthru payment before the date that is two years after the date of publication of final regulations defining the term “foreign passthru payment.” The Preamble reiterates that the Government still considers such withholding to serve an important purpose, but requests comments on alternative approaches that might serve the same compliance objectives.

Again, this deferral was not unexpected, although Treasury and the IRS seem intent upon maintaining the possibility of withholding on foreign passthru payments to provide a significant incentive for other countries to enter into, and abide by, IGAs and for financial institutions to comply with FATCA.

3. Elimination of withholding on non-cash value insurance premiums under chapter 4

Treasury and the IRS have received comments requesting the elimination of withholding under chapter 4 on premiums for insurance contracts that do not have cash value (non-cash value insurance premiums), contending that such withholding is burdensome and unnecessary.

In response to these requests – and in light of changes by the Tax Cuts and Jobs Act to Section 1297(b)(2)(B), which provides a more stringent test for determining if a non-US entity is engaged in an insurance business – the proposed regulations provide that premiums for insurance contracts that do not have cash value (as defined in Reg. Section 1.1471-5(b)(2)(vii)(B)) are excluded nonfinancial payments and, therefore, not withholdable payments. This proposed regulation can be relied upon for all open tax years.

This proposed regulation is welcome relief and a great burden reduction for collecting US tax documentation. The inclusion of insurance premiums in the definition of withholdable payments for chapter 4 purposes meant that any US entity making a premium payment to either a US or foreign insurance company needed a Form W-9 or W-8 from that insurance company to avoid an obligation to withhold. Now, premiums for most term-life and property and casualty insurance paid to a US insurance company or broker can once again be subjected to the “eyeball” test, and no withholding on premiums to foreign insurance companies should be necessary. The change only applies to non-cash value insurance premiums. Premiums paid on cash-value insurance contracts and annuity contracts continue to be treated as financial payments under FATCA.

4. Clarification of definition of investment entity

Under Reg. Section 1.1471-5(e)(4)(i)(B), an entity is an “investment entity” if the entity’s gross income is primarily attributable to investing, reinvesting or trading in financial assets and the entity is “managed by” another entity that is a depository institution, custodial institution, insurance company or an investment entity described in Reg. Section 1.1471-5(e)(4)(i)(A).

The IRS received a comment requesting “discretionary authority” to be more narrowly construed for purposes of treating an entity as “managed by” another entity. In response, the proposed regulations would clarify that an entity is not “managed by” another entity if the first-mentioned entity invests all or a portion of its assets in another entity that is a mutual fund, an exchange traded fund or a collective investment entity that is widely held and is subject to investor-protection regulation. This proposed regulation can be relied upon for all open tax years.

This approach for defining an investment entity, and therefore a financial institution, aligns more closely to FATCA local guidance in many jurisdictions and the Common Reporting Standard, and should reduce complexity for account holders and withholding agents.

5. Modifications to due diligence requirements of withholding agents

A. Treaty statements provided with documentary evidence under chapter 3

To apply a reduced rate of withholding based on a payee’s claim for benefits under a tax treaty, chapter 3 generally requires a withholding agent to obtain either (1) a withholding certificate (Form W-8) or (2) documentary evidence and a treaty statement. The 2017 coordination regulations added a requirement that, when a treaty statement is provided with documentary evidence, the statement must identify the specific limitation on benefits (LOB) provision relied upon in the treaty. The qualified intermediary (QI)
agreement in Revenue Procedure 2017-153 provides for a three-year validity period for treaty statements provided with documentary evidence and provides a two-year transition rule for accounts documented before 1 January 2017.

Treasury and the IRS received comments regarding the burden of complying with the treaty statement requirements and requesting additional time to comply. In response, the proposed regulations: (1) would extend the time for withholding agents to obtain treaty statements for accounts opened before 6 January 2017, with the specific LOB provision identified until 1 January 2020; and (2) provide indefinite validity for treaty statements with the specific LOB provision provided by tax-exempt organizations (other than tax-exempt pension trusts or pension funds), governments and publicly traded corporations.

B. Permanent residence address subject to hold mail instruction for chapters 3 and 4

The 2017 coordination regulations allow an address to be treated as a permanent residence address despite being subject to a hold-mail instruction when a person provides documentary evidence establishing residence in the country in which the person claims to be a resident for tax purposes. In response to comments, the proposed regulations provide that the documentary evidence required to treat an address that is provided and subject to a hold-mail instruction as a permanent residence address is documentary evidence that supports the person’s claim of foreign status or, for a person claiming treaty benefits, documentary evidence that supports the person’s residence in the country where the person claims treaty benefits.

The proposed regulations would also clarify the definition of a hold mail instruction to say “hold mail” does not include a request to receive all correspondence electronically.

These proposed changes can be relied upon for all open tax years.

6. Revisions related to credits and refunds of overwithheld tax

A. Withholding and reporting in a subsequent year

The proposed regulations would allow a withholding agent (including a partnership or trust) that withholds in a subsequent year to designate the deposit as attributable to the preceding year and report the amount on forms for the preceding year.

The proposed regulations would also revise the due date to file and furnish Form 1042-S to 15 September of the subsequent year when withholding occurred after 15 March of the subsequent year.

This change, required for withholding attributable to income earned in 2019, effectively means the withholding and reporting mismatch under the “lag method” that resulted in income being reported on a Year One Schedule K-1, but a Year Two Form 1042-S, would no longer exist. The proposed regulations would also resolve the reporting requirements for instances in which the liability for withholding is in Year Two while the income is treated as paid in Year One, such as withholding on Section 305(c) deemed dividends and withholding on dividend equivalents on derivatives over covered partnerships.

B. Adjustments to overwithholding under reimbursement and set-off procedures

Reg. Section 1.1461-2(a) permits a withholding agent that has overwithheld and deposited tax to adjust the overwithheld amount under either the reimbursement procedure or the set-off procedure. The proposed regulations would make various changes to these two procedures, including: (1) to allow a withholding agent to use the extended due date for filing Forms 1042 and 1042-S to make a repayment and claim a credit under the reimbursement procedure, while the current rule is limited to the due date of the return, (2) to conform the requirements for the set-off procedures to those that apply to the reimbursement procedures, and (3) to remove the requirement that a withholding agent include with its Form 1042 a statement that the filing constitutes a claim for credit when it applies reimbursement in the year following the year of the overwithholding. In addition, the proposed regulations stipulate that a withholding agent may not apply the reimbursement or the set-off procedures after the date on which Form 1042-S has been furnished to the beneficial owner or payee (in addition to, under the current regulations, after the date a Form 1042-S has been filed).

C. Reporting of withholding by nonqualified intermediaries

In response to comments, the proposed regulations would modify the rules for reporting by a nonqualified intermediary (NQI) under Reg. Sections 1.1461-1(c)(4)(iv) and 1.1474-1(d)(2)(ii) to address a case in which an NQI receives a payment for which a withholding agent has
withheld at the 30% rate under chapter 4 and reported the payment on Form 1042-S as made to an unknown recipient. In that case, the proposed regulations would permit an NQI that is a participating FFI or registered deemed-compliant FFI to report the withholding applied to the NQI on a Form 1042-S as chapter 3 withholding to the extent that the nonqualified intermediary determines that the payment is not an amount for which withholding is required under chapter 4 based on the payee's chapter 4 status.

This change would allow an NQI to facilitate foreign tax credit claims for its account holders. In many jurisdictions, chapter 4 withholding is not a creditable tax and thus account holders could not claim a foreign tax credit in their jurisdiction of tax residence for US taxes paid. Chapter 3 tax, however, is typically a creditable tax for which a foreign tax credit can be claimed.

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